Spring 2016

N. Fannon & K. Sellers' New Book on S-corp. Valuation

It has been a long time since the results of academic studies and practical valuation considerations were effectively combined, thus advancing the state of the art of business valuation. In an effort which largely solved the S corporation riddle, Nancy Fannon, CPA, ASA and Kevin Sellers, PhD have performed such feat. Their book "Taxes and Value" The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle[1] could very well be one of the most useful books in business valuation since Duff & Phelps' predecessor in the early nineties.

The academic research of the past two or three decades on taxes and value is first analyzed in details by the authors, leading to a clear conclusion that the different income taxes, which C and S corporations and their owners are subject to, do affect their respective values [2] [3]. Accordingly, several tax court cases, starting with *Gross*, if decided today, could not start from the premise that taxes do not affect values in the capital markets - as was the logic before the research was analyzed and published, because they clearly do. The authors then proceeded carefully by reviewing the court cases turning on the value of pass-through entities, listing the remaining issues which still need to be researched, analyzing the present cash flow-based S corporation valuation models, and compiling a most exhaustive bibliography.

After reviewing the research and discussing the issues, the authors advocate that:

[A] analysts remove the built-in effects of taxes on the total returns of public, C corporations from the way it is presently calculated. This derives a lower return which should be used to value S corporations because it is consistent with what the latter face, including shareholder-level taxes, but not dividend and capital gains taxes; and

[B] personal level income taxes be deducted from the cash flow of the S corporation, again because investors take this into account when such an investment is made. Such logical conclusions/recommendations are presented in detail by Chapter 8 of the book, which includes an example.

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[1] Portland, OR: Business Valuation Resources, LLC, May 2015 ISBN 978-1-62150-050-6 approx. 154 pages.

[2] C corporations pay their own tax on income. When they pay a dividend, it is taxed to their shareholders at the dividend rate, and any capital gain at re-sale is also taxed a somewhat lower rate. S corporations, on the other hand, do not pay income tax, but their owners pay regular income tax on their respective shares of S-corporation income, whether income is distributed or not. S corporation owners do not pay the dividend tax and capital gains tax on resale are adjusted for basis.

[3] Academic researchers have studied equity prices after the key tax law changes of several decades.

For any given set of input, such as starting and ending dates of the reference period, type and decile of ranked public stocks, the recommended procedure collects the following information:

Income return; capital gain return; effective individual income tax rate; effective capital gains tax rate; holding period, percentage held by institutional investors [who generally are taxed at a lower rate.] This macro-economic data is gathered from Ibbotson/Duff & Phelps, including the classic edition of the former, the Tax Policy Center, the Tax Foundation, National Bureau of Economic Research and the Conference Board: Finally, the amount of imbedded dividend and capital gains taxes is deducted from the traditional discount rate to establish a discount rate not affected by the 2 taxes which are levied on public companies' shareholders, but not on the owners of S corporations. Accordingly, the adjusted discount is applicable to pass-though entities because the latter do not pay such taxes. However, the cash flow of the pass-through being valued must first be reduced by the shareholder-level income taxes paid on its income, as the research also strongly suggests.

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business communities from his base in Darien, CT. His clients are closely-held businesses with revenues of up to $300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder and corporate disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which may affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of an attorney.

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